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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

EX PARTE

March 22, 1995

Mr. William F. Caton
Secretary
Federal Communications Commission
Room 222
1919 M Street NW
Washington, D.C. 20554

Re: CC Docket 94-1

Dear Mr. Caton:

On March 20, I met with Commissioner Ness and members of her staff, as well as representatives of NYNEX, BellSouth and the Ad Hoc Telecommunications Users Committee. There are a few points that were made at that meeting that I want to clarify:

- Seventy-seven percent (77%) of MCI's residential customers are on a discount plan.

- MCI did review the EBITDA of electric utilities and cable companies. In both instances, the operating cash flow was below that of the RBOCs. The RBOC operating cash flow margin for 1993 was 46.0% while electric utilities were at 34.1%. The cable number is included in the broader classification, "Broadcast/Cable TV" which had an operating cash flow margin of 26.8%.

I am including a summary of the operating cash flow study with this letter. Please refer to Chart 1, which shows the operating cash flow figures for several industries.

Sincerely,

Leonard S. Sawicki

Leonard S. Sawicki

cc: Commissioner Ness
Mr. Casserly

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RBOC CASH FLOW and DEREGULATION: A LEVEL PLAYING FIELD?

Executive Summary

The 104th Congress is considering telecommunications reform legislation that holds the potential to advance America's leadership in telecommunications and information technology by promoting competition in all telecommunications markets. To do so, it must recognize the inherent advantages that arise from the local telephone companies' monopoly status and acknowledge that the transition from monopoly to competition cannot be decided by a "date certain" approach. To be effective, legislation must create a level playing field for all competitors in every telecommunications market. Deregulation before de-monopolization is not true deregulation. If rules of deregulation are fair, competitive market forces will produce innovative services, increase quality and decrease prices. Such has been the experience in the competitive long distance market.

Today, that playing field is heavily skewed in favor of the Regional Bell Operating Companies (RBOCs). The RBOCs enjoy operating cash flow margins that are greater than any other major industry. In fact, they are more than four times the average for all other companies.

This cash flow is the result of an access charge mechanism that was designed to guarantee the RBOCs a fair profit level without threatening large increases in local rates. Access charges are paid by long distance companies to local telephone monopolies for completing long distance calls through the local network. In 1993, over $20 billion dollars was paid by long distance companies and their customers to the RBOCs in access charges. High access charges were sold to regulators and the public as necessary to preserve "universal service", when indeed their main effect was to guarantee the RBOCs a constant source of cash flow far in excess of what was needed to serve social objectives.

The RBOCs have used this unreasonable cash flow to maintain excessive profit levels, to fund ventures outside of local telephone service and to make enormous dividend payouts. In addition, they are funneling substantial funds offshore. This paper explains how RBOC operating cash flows generated by monopoly rates and access charges, if left unchecked, will place the RBOCs at such a competitive advantage in both the local and long distance markets that competition could be seriously undermined.

Among this paper's key findings are:

- The RBOCs' operating cash flow margin (46%) is the highest in American industry, exceeding those of oil companies (37%), electric utilities (34%) and drug companies (27%). Contrast the RBOC margins with those of competitive long distance companies (19%).

- RBOC operating cash flow margins have been consistently 46% or higher since the Bell System break-up in 1984.

- While the revenue figures for the RBOCs ($71 billion) and long distance companies ($64 billion) are roughly comparable, RBOC cash flow ($33 billion) is almost three times that of the competitive long distance companies ($12 billion).

- Access charges paid by long distance companies and their customers give the RBOCs a 71% margin and account for 45% of the excessive RBOC operating cash flows.

- The huge margins in access charges allow the RBOCs to self-fund their investment activities. Unlike companies in competitive markets, they have rarely sought funding from capital markets.

Without legislative changes which de-monopolize local markets before allowing RBOC entry into other markets and which reduce access charges to cost, the RBOCs can effectively prevent local competition, as they have to date, while also cross-subsidizing their entry into long distance from their monopoly local franchises. They have the ability to do this because they have operated as government-sanctioned monopolies and their profits have never been disciplined by the competitive market. The RBOCs have no competition and no market pressures to drive prices down toward costs.

Operating Cash Flow is a Measure of Company Strength and Value

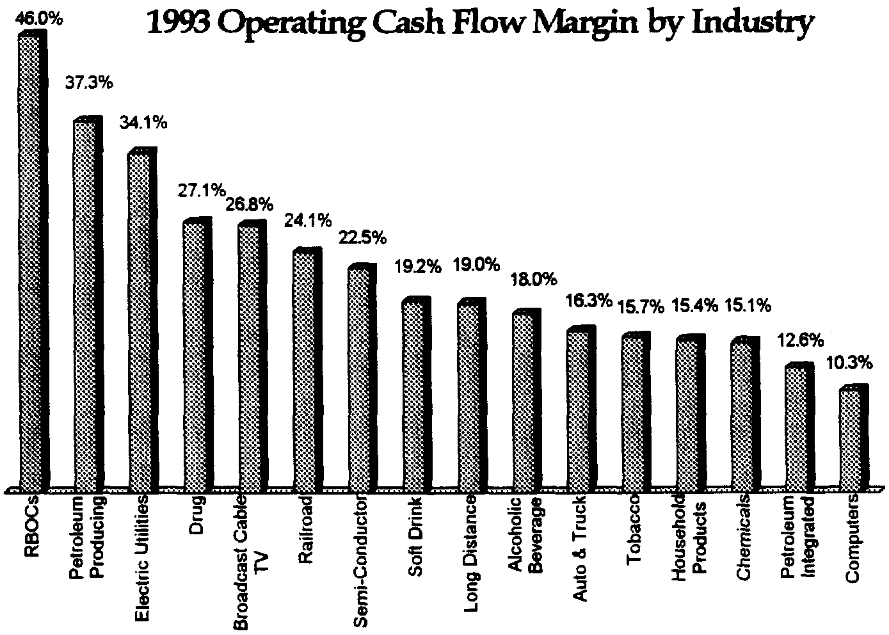
Operating cash flow (OCF) is the cash a company has to spend in a given year after it collects revenues from its customers and pays its employees and suppliers for non-capital expenditures. OCF is also referred to as EBITDA, or a company's Earnings Before Interest Expense, Taxes, Depreciation and Amortization. OCF, rather than net income or operating income, is commonly used in the financial community to determine the relative strength and value of a company because it is a measure of a firm's cash flow from ongoing business operations. Some expenses, such as depreciation, are reported on a company's financial statements and reduce income, but they have no effect on cash flow. A firm doesn't send a check to a supplier for the "non-cash" expense of depreciation. It is an "accounting" expense rather than a cash expense. OCF is considered to be the best measure of a company's strength and value.

Our analysis was compiled from data on file at the Federal Communications Commission (FCC) and from other public sources of information. The compilation of the underlying FCC data was verified by Price Waterhouse LLP.

In 1993, RBOC Operating Cash Flow Margins Exceeded All Other Industries

In 1993, the OCF margin for the seven RBOCs was 46%. This is a full 12% higher than electric utility monopolies and is the highest operating cash flow margin in American industry. Many industries are highly infrastructure-intensive (e.g., electric utilities and railroads), but none can claim the ability to generate as high an OCF margin .

Chart 1



Notes:

1). Sources: Regional Bell Companies - FCC Preliminary Statistics of Communication Common Carriers for year ended December 31, 1993 ; Long Distance - Company Annual Reports; Electric Utilities - Disclosure, Inc.; all other industries are from The Value Line Investment Survey - 1994 editions.

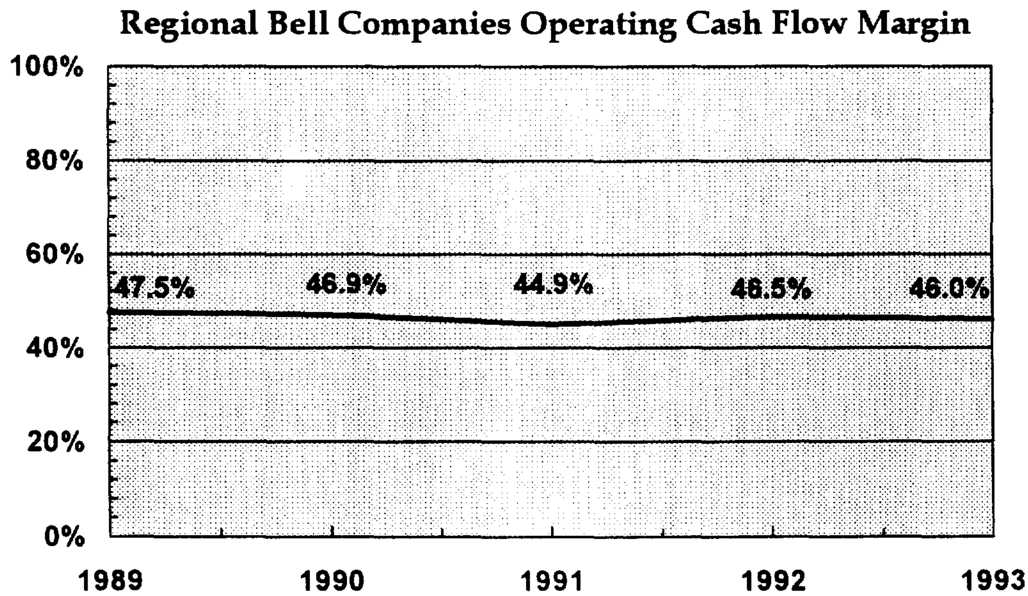
2). The Long Distance industry composite is comprised of MCI, LDDS, ALC, LCI, AT&T and Sprint long distance services.

The RBOCs claim that their high OCFs are due solely to the capital intensity of their business and their resulting high depreciation expenses. This is not so. While infrastructure-intensive industries will have higher depreciation charges, and usually higher cash flow, this alone does not explain the magnitude of the cash flow received by the RBOCs relative to other industries. Much of the excessive cash flow margin of the RBOCs represents excess profits used to subsidize competitive ventures outside their core local telephone business. For instance, the RBOCs' return on equity is far above that of other firms facing comparable business risks and has remained high, even during periods of falling capital costs in the economy.

RBOC Operating Cash Flow Margins Have Remained Constant

The RBOCs OCF margin was about 46% at the time of the Bell System divestiture in 1984 and has remained constant. The RBOCs have a monopoly on local, access, and intraLATA toll services and have enjoyed a guaranteed rate of return, free from cost-cutting pressures and incentives to achieve gains in efficiencies that characterize competitive markets. The constant level of RBOC OCF demonstrates that RBOC claims of local competition are false.

Chart 2



Source: Statistics of Communications Common Carriers published by the FCC for years ended 1989 through 1993.

The RBOCs Generate Over Two Times the Operating Cash Flow of Long Distance Companies

Chart 3 compares the RBOCs' and long distance companies' revenue and cash flows. These entities have comparable revenues, but the RBOCs have an enormous operating cash flow and market capitalization advantage over the long distance companies. The RBOCs' market capitalization -- i.e., what Wall Street thinks each is worth -- is two and half times the size of the long distance carriers' market capitalization. RBOC OCF ($33 billion) is almost three times the size of the long distance industry ($12 billion).

Chart 3

Long Distance Companies	1993	RBOCs	1993
Net Revenue	$64B	Net Revenue	$71B
Market Capitalization (estimated)	$60B	Market Capitalization (estimated)	$148B
Operating Cash Flow	$12B	Operating Cash Flow	$33B
Operating Cash Flow Margin	19%	Operating Cash Flow Margin	46%

Notes:

1). Sources: FCC Preliminary Statistics of Communication Common Carriers for year ended December 31, 1993; FCC Report 4303; FCC Report 4302; 1993 BusinessWeek 1000; Company Annual Reports and 10Ks. The compilation of the underlying RBOC FCC data was verified by Price Waterhouse LLP. RBOC net revenue excludes wireless.

2). The long distance industry composite is comprised of MCI, LDDS, ALC, LCI, AT&T and Sprint long distance services.

3). The market capitalization for AT&T and Sprint has been estimated based on long distance operating income as a percentage of total Company long distance operating income.

This operating cash flow gives the RBOCs a tremendous advantage in their ability to internally fund large-scale capital expenditures and conduct expensive sales and marketing campaigns.

Access has a 71% OCF Margin and Represents 45% of RBOC OCF

The RBOCs' cash flow from excessive access charges paid by long distance companies and their customers creates an imbalance between the RBOCs and other sectors of the telecommunications industry. Chart 4 depicts how lucrative this business line is for the RBOCs. Access has a 71% operating cash flow margin. Access alone represents 45% of OCF for the RBOCs.

Chart 4

1993 OCF by Line of Business

	Net Revenue	Operating Cash Flow	Operating Cash Flow Margin	% of Total
Local	$34.2B	$ 7.5B	22.0%	23%
Access	$20.8B	$14.7B	70.7%	45%
Toll	$ 9.7B	$ 6.4B	66.1%	20%
Misc.	$ 6.6B	$ 4.1B	63.0%	12%
Total	$71.3B	$32.8B	46.0%	100%

Sources: See Chart 3, Note 1.

Despite the RBOCs' claims to the contrary, only a small portion of their operating cash flow is used to subsidize universal service. A 1994 study conducted by Hatfield and Associates, of Boulder, Colorado concludes that the cost of providing universal service to high cost areas is $4 billion annually. The RBOCs take in over $20 billion in access fees per year.

Excessive Access Charges Fund Dividends and New Ventures

Chart 5 shows how the $20.8 billion collected by the RBOCs for access generates $14.7 billion in operating cash flow. After expenses and reinvestment in local plant, the RBOCs' high margin access "windfall" gives them a minimum of $4.4 billion dollars to spend on dividends and other investments. The RBOCs rarely go to the U.S. capital markets for any meaningful financing because they can self-fund their investment activities. During the period 1991 through 1993, $15 billion was invested in new ventures. Only $1.7 billion was capitalized through external funding.

Chart 5

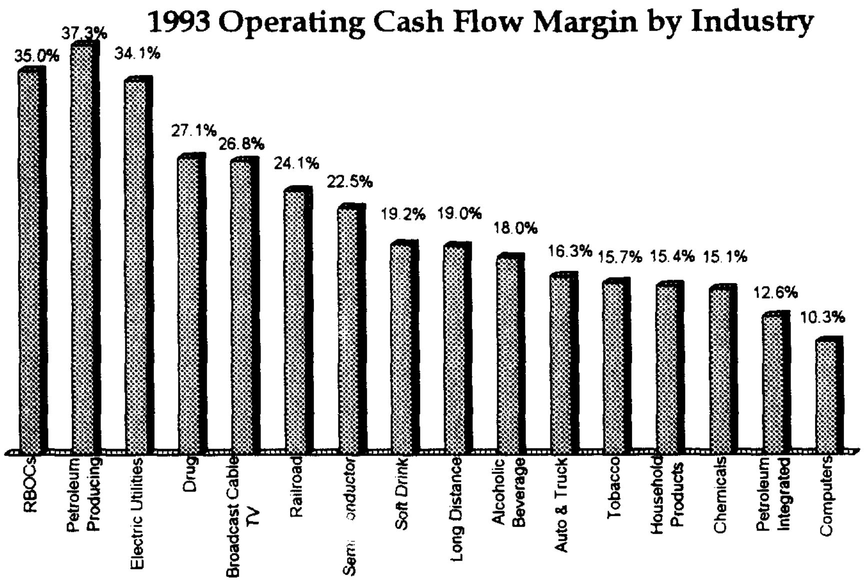
	1993
Net access charges received by Regional Bell Companies	$20.8B
Operating Cash Flow margin on access charges	x 70.7%
Operating Cash Flow on access charges	$14.7B
Amount reinvestment in local plant (reinvestment rate is 44.5% on OCF)	$6.5B
Net interest expense (estimated rate is 9.6% on OCF)	$1.4B
Accrued taxes (estimated taxes rate is 16.5% on OCF)	$2.4B
Available for dividends and investment in new ventures	$4.4B

Sources: See Chart 3, Note 1.

RBOC OCF Margin <u>Without</u> Access Exceeded Most Industries

Even without access charge revenue and costs, the RBOCs' operating cash flow margin is 35%, still topping most American industries.

Chart 6



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1). Sources: Regional Bell Companies - FCC Preliminary Statistics of Communication Common Carriers for year ended December 31, 1993 ; Long Distance - Company Annual Reports; Electric Utilities - Disclosure, Inc.; all other industries are from <u>The Value Line Investment Survey</u> - 1994 editions.

2). The Long Distance industry composite is comprised of MCI, LDDS, ALC, LCI, AT&T and Sprint long distance services.

The RBOCs, through their government-sanctioned monopoly, have generated enough cash to modernize and digitize their inter-office networks and to construct long distance "administrative" fiber optic networks within their regions. In addition, they've had the cash to invest billions of dollars overseas in foreign cellular and cable television infrastructures, invest billions in real-estate, and capture almost half of the U.S. cellular market. Now the RBOCs are going on a spending spree in Hollywood with monopoly funds.

What the RBOCs have failed to do, notwithstanding the FCC's "price cap" incentive regulation approach, is to modernize the "bottleneck" local loop, the last mile of the network which connects each business and consumer to the outside world. Recent RBOC performance shows that such price deregulation does not lead to RBOC infrastructure investment. Ironically, the RBOCs are pressing Congress and the FCC for even more deregulation and immediate entry into all sectors of the telecommunications market.

The RBOCs possess a generous government-granted lead in amassing cash flows which will be utilized in cross-subsidizing forays into competitive markets. They possess the ability to hamper competition in the local loop because all new entrants must interconnect with them and they can charge inflated prices for these essential interconnections.

Only Real Local Competition Will Eliminate the RBOC Advantage

The only challenge to the RBOC advantage is the development of real local competition. Unfortunately, as long as they retain their local monopolies, the RBOCs can cross-subsidize their entry into other telecommunications markets such as long distance in a way that could seriously impair or destroy the competitive markets that exist. The RBOCs also have the ability to use their monopoly powers to impede competitors from entering the local telecommunications market in any meaningful way.

The RBOCs have cross-subsidized their investment in the U.S. and abroad in cellular, paging and other non-regulated endeavors. Establishing separate subsidiaries and requiring the imputation of access charges are fundamental post-entry safeguards. However, these safeguards are not sufficient to prevent anticompetitive behavior without the development of effective local competition prior to RBOC entry into long distance. Imputation of access charges does not alter the cash flow of an RBOC or its ability to cross-subsidize its competitive activities. To the extent the competitive part of the RBOC faces the same access charges as its competitors, this cash will simply be going out of one pocket and into the other.

Conclusion

Telecommunications reform legislation must address the key issues of bringing real competition to all sectors of the telecommunications marketplace. Conditions for fair competition to develop are:

- *Eliminate the monopoly access charge "entitlement" program before unleashing the RBOCs into other markets. It is from this revenue source that the excessive cash flows are largely being generated. Access rates must be reduced to cost.*

- *Adopt policies for fair competition in local telephone service, including:*

    1. *Eliminate franchise restrictions.*

    2. *Require that all competitors have equal access to conduits and rights-of-way.*

3. *Require number portability and dialing parity.*

4. *Require existing local telephone companies to offer potential competitors use of "unbundled" network functions.*

5. *Require that pricing of network functions be based on cost and be non-discriminatory.*

6. *Eliminate restrictions on resale and sharing.*

7. *Achieve cost-based, competitively-neutral universal service reform.*

- *Ensure that effective local competition develops before the RBOCs' entry into competitive markets is permitted.*

- *Establish strong post-entry separate subsidiary and imputation safeguards. The separate subsidiary safeguards need not only to be arm's length, but must also require the subsidiaries to compete equitably for funding in the capital markets and not be internally funded from the RBOCs' monopolist generated cash flows.*

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